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# Investment Strategy
# 14 November 2011


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## The eurozone crisis still holds centre stage

Despite the 26 October summit and the announcement of measures designed to halt the crisis, the eurozone is still worrying and is the chief concern of markets. We do not think that the prerequisites for an end to this crisis have been met as yet. In our opinion, the situation could stabilise only when cases of insolvency have been identified and dealt with by the EMU (this includes Greece, but also, at least, Portugal). Now, at present, these countries seem to have fallen into a vicious circle of recession, deficits and austerity policies: given the current deep recession, austerity is not reducing the deficits. The eurozone will therefore have to help them stimulate their economies and/or restructure their debt again in the future, despite the announcements at end October concerning Greece. A second stabiliser would have to come from the establishment of a public debt buyer of last resort to help those countries that are technically solvent but faced with a liquidity problem. Since the ECB refuses to play this role (apart from temporary purchases) and some countries support it in this decision, the new EFSF will have to be set up in the coming weeks, to restore visibility to countries such as Italy whose financing costs have spiralled. Lastly, we believe that longer-term it is important for Europe to plot a path toward closer economic integration, in order to establish systems of income transfers between countries which would make sharing the same currency acceptable to all. It is easy to see the political difficulty of this undertaking. In the medium and long term, we believe these transformations are possible and will enable a stabilisation of the zone, but the path is bound to remain difficult.

## Beware of "pro-cyclicality" risk

Apart from the financial aspects of this crisis, our caution is justified by the pro-cyclical nature of European economic policy. When a recession is beginning, the eurozone is betting on increased austerity to reinforce its fiscal credibility. Deficit reduction measures are accordingly being accelerated (Italy, France, etc.) and banks are urged to trim the size of their balance sheets (with the risk of credit tightening which this entails). This decision remains bold (there are very few historical examples of a pro-cyclical policy at the start of a recession) and is likely to weigh heavily on economic conditions in 2012. Admittedly, monetary policy is becoming more accommodative as a result of the recent ECB interest rate cut, and this bias will probably be confirmed.

The picture is less clear-cut outside the eurozone: the US economy is stabilising at a low but positive growth rate, and emerging markets are expected to maintain their growth rates. Given the nature of the risks raised by the EMU crisis at a time when global growth lacks powerful momentum, however, we think that the environment could remain difficult. Equity markets and the euro have been relatively resilient to the deterioration of peripheral bond markets until now. However, the financial stress could affect them far more adversely, and we do not rule out new lows in the coming months if subjects such as the solvency of Italy and its financial implications continue to worry investors. Our recommendations therefore remain similar to those in October, including an underweighting of developed equities and a search for alternatives.

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# ASSET ALLOCATION

## Allocation decisions

- Negative recommendation on developed equities, and neutral on emerging equities, for which we maintain a preference.
- Virtually neutral on government bonds and credit. We are waiting for a window to return to emerging debt in local currency.

## Developed equity market arbitrage

- We recommend a relative overexposure mainly to Japan and the United Kingdom and we return to a neutral position on the United States.
- Negative position maintained on eurozone equities.
- Neutral on Switzerland, underweight on Canada and Australia.

## Emerging equity market arbitrage

- Unchanged preference for China, and to a lesser extent Russia.
- Neutral on India, South Korea and South Africa.
- Underweight on Turkey, Taiwan and Brazil (reducing holdings for the latter).

## Recommended allocation – Investment Strategy Team

### ASSET ALLOCATION MODEL PORTFOLIO — November 2011

MULTI-ASSET CLASS [1]

| | Alpha | Current weight | Previous weight |
|---|---|---|---|
| **EQUITIES** | | | |
| Developed Equities | -0.10 | -0.6% | -0.5% |
| Emerging Equities | 0.07 | 0.2% | 0.3% |
| **FIXED INCOME** | | | |
| Government Bonds | 0.08 | 2.5% | 3.1% |
| Investment Grade | -0.03 | -0.9% | 0.5% |
| High Yield | -0.08 | -1.2% | 1.3% |
| Emerging Debt | 0.04 | 0.4% | -0.8% |
| Emerging Debt Local | 0.04 | 0.5% | 0.4% |
| **COMMODITIES** | | | |
| Brent Oil | -0.04 | -0.1% | -0.3% |
| Base Metals | 0.05 | 0.4% | 0.9% |
| Gold | 0.45 | 2.3% | 2.2% |
| Agricultural | -0.03 | -0.2% | -0.5% |
| Cash Euro | | -3.3% | -6.8% |
| Module Total | | 0.0% | 0.0% |

| PORTFOLIO STATISTICS | |
|---|---|
| Target Ex-ante Volatility | 2.00% |
| Real Ex-ante Volatility | 1.08% |

EQUITY DEVELOPED COUNTRIES [1]

| | Alpha | Current weight | Previous weight |
|---|---|---|---|
| US | 0.01 | 0.2% | 1.0% |
| Canada | -0.08 | -2.0% | -2.9% |
| Euroland | -0.10 | -2.8% | -2.5% |
| Japan | 0.10 | 1.8% | 2.3% |
| UK | 0.11 | 4.0% | 3.2% |
| Switzerland | 0.05 | 1.6% | 0.5% |
| Australia | -0.09 | -2.8% | -1.5% |
| Module Total | 0.00 | 0.0% | 0.0% |

BOND COUNTRIES SOVEREIGN [1]

| | Alpha | Current weight | Previous weight |
|---|---|---|---|
| US | -0.25 | -16.0% | 0.0% |
| Euroland | 0.13 | 8.3% | 0.0% |
| Japan | 0.00 | 0.0% | 0.0% |
| UK | 0.13 | 7.6% | 0.0% |
| Switzerland | 0.00 | 0.0% | 0.0% |
| Module Total | 0.00 | 0.0% | 0.0% |

EQUITY EMERGING COUNTRIES [2]

| | Alpha | Current weight | Previous weight |
|---|---|---|---|
| Brazil | -0.07 | -0.5% | -1.1% |
| China | 0.27 | 1.8% | 3.6% |
| India | 0.06 | 0.4% | 0.4% |
| South-Korea | 0.00 | 0.0% | 0.3% |
| Taiwan | -0.26 | -1.7% | -3.2% |
| Russia | 0.23 | 1.1% | 1.7% |
| South Africa | -0.01 | -0.1% | 0.1% |
| Turkey | -0.23 | -1.0% | -1.8% |
| Module Total | 0.00 | 0.0% | 0.0% |

1-Hedged in Euro, 2-Local Currency

*Source: BNPP AM*

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# ECONOMIC OUTLOOK

## VIEWPOINT

### Modest US growth stimulated by economic policy

***Growth rebound in the third quarter***

In the **United States**, GDP growth accelerated in the third quarter from a very disappointing first half (0.4% in the first quarter and 1.3% in Q2) in which, it will be remembered, fears arose of a relapse into recession. As we expected, at a 2.5% annualised rate, growth proved satisfactory even though it is still moderate. In addition, the components of domestic demand are encouraging in the short term, with a negative contribution from inventories (-1.1 pp) suggesting that this factor could be corrected in the coming quarter. Moreover, even after a fine quarterly growth rate (17.4% at an annualised rate), the share of productive investment in GDP (about 10%) is still very far from the level that should be seen more than two years after the end of the recession. In the coming quarters, capital goods obsolescence should translate into sharper growth in capital expenditure, as shown by manufacturing orders. Moreover, the purchasing manager survey indices (ISM) are holding up above 50, reflecting an expansion of activity both in the manufacturing sector and in services.

***The manufacturing sector is weathering the contraction in global activity***

For the past two quarters, **residential investment** has no longer held back growth, due to the stabilisation of the real estate market. It is still far too soon to speak of an improvement, given that one-third of existing home sales consist of foreclosed property, which adversely affects prices and creates "unfair" competition for the new housing market. Moreover, some of the transactions are paid for in cash by investors aiming at the rental market while, according to the real estate developers, households cannot easily obtain loans and may, for this reason, have to abandon their projects. However, the banks surveyed by the Fed state that they have not tightened their conditions for granting this type of credit. Following a second quarter marked by a sharp contraction in durable goods purchases (-5.3%) due to the unavailability of numerous car models (a consequence of the disruption of production in Japan), private consumption bounced back in the third quarter, from 0.7% to 2.4%. This pace is satisfactory, but is partly due to a fall in the savings rate (from 5% at the start of the year to 3.6% in September, the lowest level since the end of 2009). A sharp pickup in consumption is essential to ensure enduringly more sustained growth in the economy. Such a scenario is hard to imagine so long as **employment** weighs on households' morale and will limit wage growth. Job creations, although rising (153,000 per year in the private sector since the start of the year), are insufficient to bring down the unemployment rate (9%). In real terms, household income is growing by less than 3% at present, so private consumption is expected to increase by 2% to 2.5% in the coming quarters (assuming a reasonable rebuilding of savings faced with the uncertainties regarding growth and fiscal policy). Such a result is better than at the start of the year but remains below historical performances.

***Still the same weaknesses: real estate and employment***

***The Fed is watching***

The Fed announced no change in its **monetary policy** at its last meeting held in early November. It presented economic projections revised downward compared with the figures published in June, and does not expect to see the unemployment rate go well below 8% until 2014. The tone of official commentary is increasingly cautious regarding the economic situation, which suggests that monetary policy will remain very accommodative, or even that a further quantitative easing programme will be announced soon, even before June 2012 when "Operation Twist", presented in September, is due to end.

### Consensus Forecasts: Growth & Inflation

| | GDP YoY % | | | | | | | | | Inflation YoY % | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011 | | | | 2012 | | | | 2010 | 2011 | | | | 2012 | | | |
| M= Mean; H= High; L=Low | | M | H | L | -1M | M | H | L | -1M | | M | H | L | -1M | M | H | L | -1M |
| **Developed Economies** | | | | | | | | | | | | | | | | | | |
| **USA** | 3.0 | **1.7** | 1.9 | 1.5 | [1.6] | **1.9** | 3.1 | 0.4 | [2.1] | 1.6 | **3.1** | 3.3 | 2.8 | [3.1] | **2.1** | 3.3 | 1.3 | [2.1] |
| **Canada** | 3.2 | **2.3** | 2.7 | 2.1 | [2.3] | **2.0** | 2.5 | 1.5 | [2.1] | 1.8 | **2.8** | 3.1 | 2.7 | [2.8] | **1.9** | 2.5 | 1.4 | [2.0] |
| **Eurozone** | 1.7 | **1.6** | 1.8 | 1.5 | [1.7] | **0.6** | 1.4 | -0.5 | [1.0] | 1.6 | **2.6** | 2.7 | 2.4 | [2.6] | **1.8** | 2.5 | 1.3 | [1.8] |
| **UK** | 1.8 | **1.0** | 1.6 | 0.8 | [1.2] | **1.5** | 2.4 | 0.7 | [1.8] | 3.3 | **4.4** | 4.5 | 4.2 | [4.4] | **2.7** | 3.6 | 2.1 | [2.7] |
| **Switzerland** | 2.7 | **2.0** | 2.3 | 1.6 | [2.0] | **1.1** | 2.0 | 0.0 | [1.3] | 0.7 | **0.4** | 0.5 | 0.3 | [0.5] | **0.4** | 1.0 | -0.2 | [0.7] |
| **Japan** | 4.0 | **-0.5** | 0.0 | -1.1 | -[0.5] | **2.2** | 3.5 | 0.9 | [2.4] | -0.7 | **-0.2** | 0.3 | -0.5 | -[0.2] | **-0.2** | 0.8 | -0.9 | -[0.2] |
| **Australia** | 2.7 | **1.7** | 2.2 | 1.2 | [1.8] | **3.5** | 4.6 | 2.5 | [3.7] | 2.8 | **3.4** | 3.7 | 3.0 | [3.4] | **2.9** | 3.4 | 2.1 | [2.9] |

*Source: Consensus Forecasts as of 10/10/2011*

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# DEVELOPED ECONOMIES

## The eurozone is likely to experience another recession

***Very gloomy surveys***

In the eurozone, if we try to turn our attention away from the political turmoil and look at the economic data, there's nothing but **bad news**. A relapse into recession now seems inevitable, while the survey results continued to deteriorate in September and October, contrary to what has been seen in the United States. The PMI indices, which reflect purchasing managers' sentiment, mostly fell below 50 in September. In October, the composite index (manufacturing and services) lost 2.6 points, coming in at 46.5 for the euro zone as a whole, the lowest level since June 2009. Even more critically, the situation of those EU member states that had previously shown resilience, such as France and Germany, deteriorated sharply (indices at 45.6 and 50.3 respectively), while the other two major European economies (Italy and Spain) tilted into recession (43.1 and 41.7). An economic contraction is likely following modest growth in the third quarter. The consensus of private economists (*see previous page*) does not yet fully reflect this situation. Further downward revisions of the forecasts, fuelling pessimism, are therefore likely.

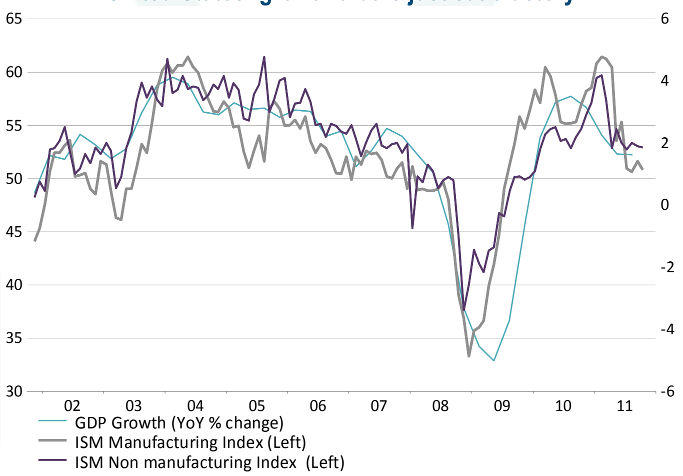
***A growing awareness of the difficulties ahead***

In its autumn forecasts published on 10 November, the European Commission revised its growth figures and now projects 0.5% for 2012 versus 1.9% in the spring forecasts. The figure (close to the consensus) still appears too high and contrasts with the very pessimistic official commentary: "sharply deteriorated confidence is affecting investment and consumption, weakening global growth is holding back exports, and urgent fiscal consolidation is weighing on domestic demand". This assessment, shared by the ECB, is pertinent and substantiated by the available indicators. Consumption has already started to falter while employment has stopped improving, and output and new manufacturing orders are wilting.

***The ECB will have to force itself to act***

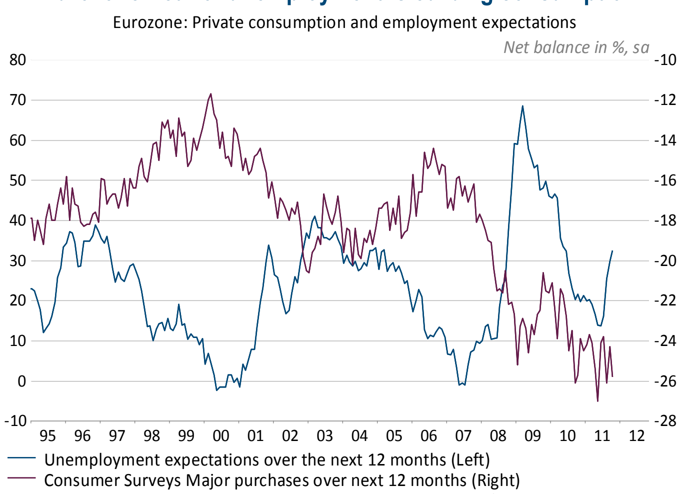
Against this backdrop, **the 25 bp cut in the ECB's key rates** announced on 3 November will be insufficient to restore either confidence or, of course, activity. And yet monetary policy seems to be the only tool available at a time when restrictive fiscal policies are increasingly widespread and credit growth is slowing, due to the effects of both supply and demand. The ECB is expected to lower its key intervention rates further (and could even take the refi rate below 1%, which is the lowest level ever reached as yet). It will also maintain unlimited refinancing for banks. Now that the sovereign crisis has spread, it would be advisable for the ECB to present itself "officially" as the buyer of last resort, given that the overhauled EFSF resulting from the 26 October European summit is not yet operational. Since the resumption of its purchases of government bonds under the SMP (Securities Markets Programme), it has bought bonds worth EUR 110 billion (bringing the total since the creation of the SMP to EUR 183 billion), while stating that the programme continues and is designed to improve monetary policy transmission. The announcement of a veritable QE policy (with an ambitious debt purchase target) would have the merit of giving Italy time to settle its liquidity problem before it turns into a solvency problem (which is not inherent in the imbalances of Italian public finances). Despite this, the sovereign crisis would not be settled, but such a decision would possibly enable the Member States to be freed of market pressure in order to return to a more counter-cyclical economic policy than the current escalation of budget restrictions.

**United States: growth that is just satisfactory**




*Source: Factset, BNPP AM*

**Eurozone: fear of unemployment is curbing consumption**




*Source: Factset, BNPP AM*

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# EMERGING ECONOMIES

## Further deterioration of the economic cycle

***Emerging economies are resilient, despite the increasing volatility coming from developed economies***

The emerging countries' economic cycle continues to slowdown, according to the leading indicators and opinion polls. The economies that are most cyclical and most exposed to external demand, such as Taiwan, are especially impacted. The industrial production cycles of emerging and developed countries have diverged since the slowdown in early 2011, reflecting a certain resilience of domestic demand in the emerging countries. However, a complete decorrelation of the cycles as occurred in the major financial crisis of 2008 can be ruled out, because this time China is far more reluctant to stimulate its economy aggressively with major stimulus packages.

We believe that the current slowdown is mainly cyclical and is normal in view of the sharp rebound from the cycle low in 2008. As a reminder, emerging countries' industrial production and exports have surged 30% and 33% respectively since the low of 2008, versus 10% and 24% respectively for developed countries. However, things could get out of control if final demand deteriorates in the developed countries, or if Western banks sharply reduce their exposure to emerging countries, especially the East European countries. With regard to economic statistics, Latin America and Eastern Europe post better than expected figures, while the situation is slightly less favourable in Asia.

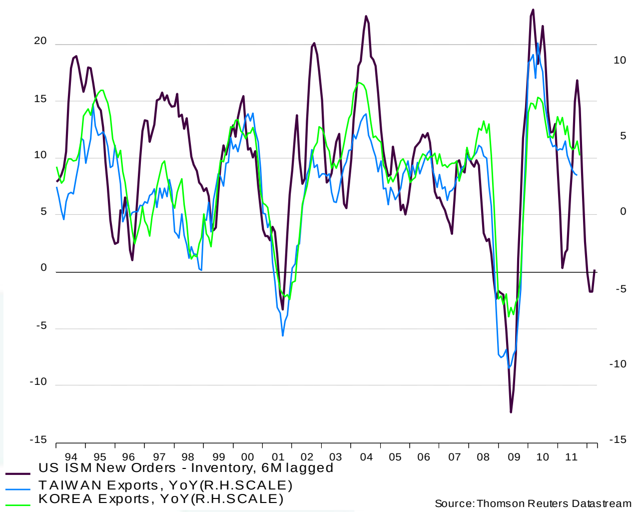
***Inflationary pressures are less worrying. Interest rate cuts in Brazil and Indonesia***

Most of the emerging PMI indices have improved since the previous month. The trend in the differential between new orders and stock levels is also positive in most of Asia, except for South Korea and Taiwan. These two countries are especially exposed to the technology industry cycle. Except in India and Brazil, inflation has exceeded its cycle peak, so that monetary authorities can adopt a less restrictive policy, or even a deliberately expansionary policy. This is the case for Brazil and Indonesia, which have both lowered their rates for the second time running. The lack of visibility in the developed economies, the recent deceleration of commodity prices and signs of a slowdown in domestic demand are all factors pointing to a further slowdown in inflation.

***Soft landing in China. Falling real estate prices. Selective easing***

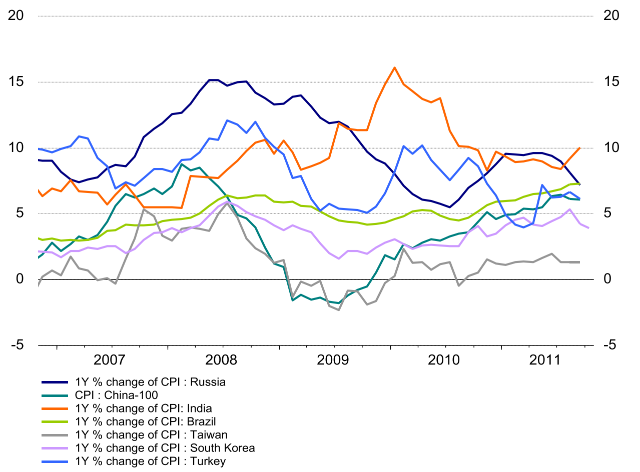
With a PMI Index stabilising slightly above 50 in October, especially for the non-manufacturing sector, the Chinese economy is generally very resilient. Inflation is becoming a secondary problem, although the level is still high. Monetary policy is nearing an inflection point, and further easing measures can be expected in the coming months. The M1 and M2 liquidity indicators are near all-time lows, while new bank loans are rebounding, reflecting selective monetary easing for small and medium-sized businesses. Real estate prices are at last starting to fall in the large cities, in response to numerous interventions by the authorities. Some real estate developers in the rich city of Wenzhou are trying desperately to liquidate their stocks and are even offering a luxury car for the purchase of any new apartment, which is reminiscent of the period just before the subprime crisis. The trend in real estate prices is of crucial importance, because construction accounts for 15% of GDP, and real estate for over half the wealth of a Chinese household.

**Exports will probably continue to decline**




Source: Thomson Reuters Datastream

**Emerging-country inflation is declining**




Source: Thomson Reuters Datastream

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# BOND MARKETS

## GOVERNMENT BONDS

### Economic activity remains weak, and the uncertainties in Europe have not disappeared

From an economic viewpoint, the figures seem to be stabilising in the United States, thus alleviating fears of a double-dip recession. This reassures us only partially, because we believe that the country still needs monetary and fiscal stimulation to achieve slightly positive growth rates. President Obama's stimulus plan could boost the GDP growth rate depending on the number of proposals approved, but the underlying trend is still weak.

***The Fed revises its growth forecasts downward***

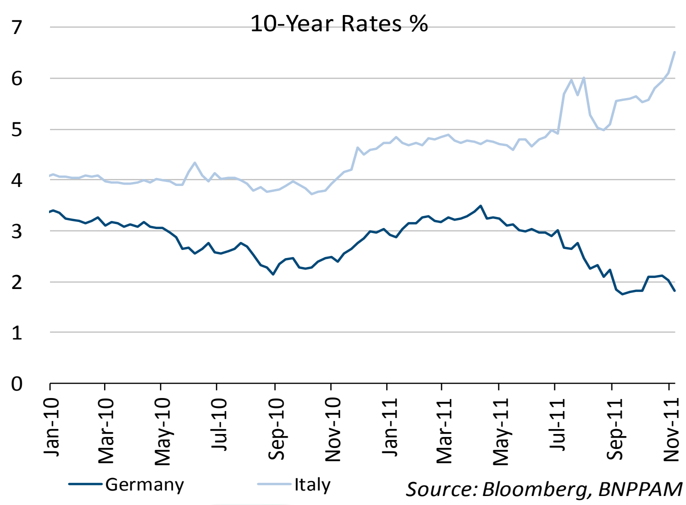
For its part, the Fed has revised downward its growth forecasts for next year, and revised its unemployment rate forecasts upward. At its last meeting, it was important for us to have more information regarding the further measures that the central bank could take if necessary, and in particular its communication strategy and the strategy of further MBS purchases. Regarding the first point, Ben Bernanke is apparently more prepared to tie the level of key interest rates to employment or inflation levels rather than growth, and to publish more information concerning the future path of interest rates, like what he has already done by announcing that current interest-rate levels would be left unchanged until mid-2013. Regarding the second point, it would seem that such a measure is on the table, but the Committee is still undecided. All this leads us to expect low short-term interest rates for a long time, a very directional yield curve and long-term interest rates that are still at low levels for the time being.

***The EU summits are a step in the right direction, but there is still a lack of details***

As regards Europe, we have had important summit meetings which have confirmed the shared determination to find solutions, but which were also poor in details regarding the proposed measures. At the same time, the situation has become even more complicated in the cases of Greece and Italy. All in all, the complex decision-making process for an exit from the crisis, the fiscal austerity measures to be implemented, political uncertainty in some countries and problems related to bank funding give us a portrait of the euro zone that is not very encouraging. Economists' growth forecasts have again been revised downward, and we expect this trend to persist.

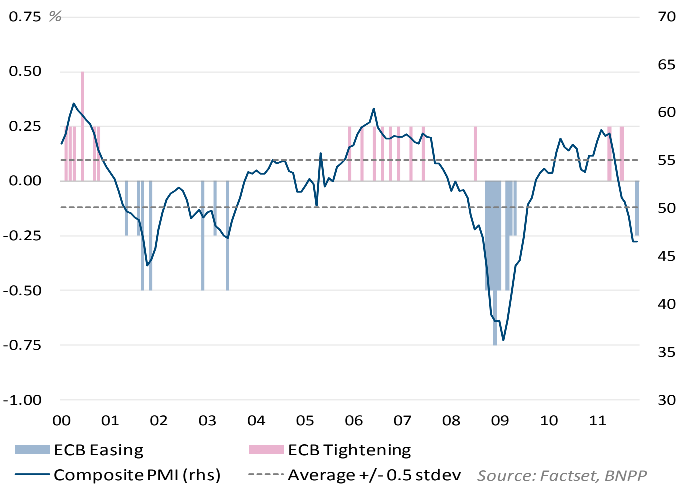
The ECB, for its part, already lowered its rates at the first meeting chaired by Mario Draghi, who in this respect seems to have a slightly longer-term view than his predecessor, but who keeps the same approach regarding the extraordinary nature of bond purchase operations. We expect another 25 basis point cut in interest rates, justified by the current sluggish economic conditions. In this context, German long-term yields will also remain at low levels.

**Further stress for Italy**




Source: Bloomberg, BNPPAM

**The ECB's interest rate cuts are justified**




Source: Factset, BNPP AM

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# IG AND HY CREDIT

## Europe still weighs on credit

Although, on the one hand, the economic environment in the United States should help support credit, including the most speculative issues, the news from Europe is not very reassuring.

*US High Yield better positioned than its European counterpart*

US growth seems to be heading toward low but positive levels, although fiscal stimulus, the form of which is still uncertain, will still be needed to counter persistent fundamental weakness. In theory, this context should not be negative for credit, where valuations are attractive, the fundamentals healthy and the asset class still attractive in an environment of very low underlying interest rates.

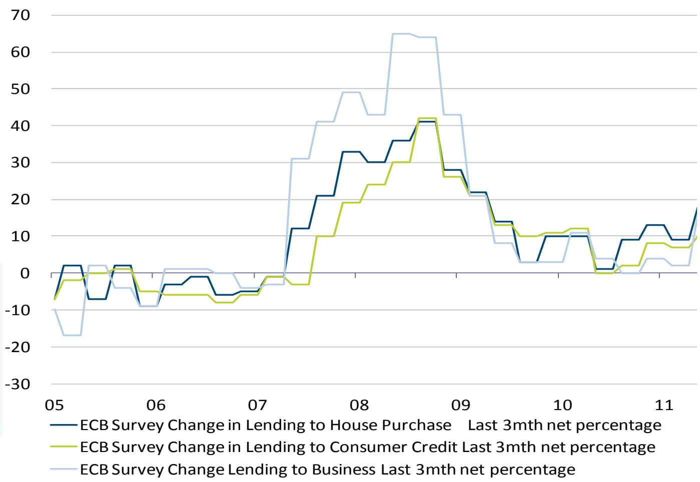
However, the market at present unfortunately seems to be driven more by events in Europe, where the sovereign crisis remains tense. The proposals put forward by governments at the recent meetings go in the right direction, but do not provide much concrete information to reverse the trend. Although European growth will face a difficult period, with leading indicators that suggest another recession to come, it must also be recognised that companies are in better health now than in 2008.

*European banks in difficulty*

With regard to banks, the difficulties of European governments are weighing on financial institutions which hold government debt. The consequence of this is a drying-up of the primary market, which prevents balanced funding, apart from the short-term liquidity provided by the ECB. The authorities are well aware of this, and have agreed on guarantees to enable the banks to come to the markets more easily. While we consider this a good initiative, aimed among other things at limiting a contraction in balance sheets, its implementation, which should take place at the European and not the national level, seems harder to achieve. At the same time, this point is crucial, because there is currently a deterioration in European banks' lending conditions, which indicates that their difficulty in obtaining access to the market is becoming an increasingly significant factor weighing on corporate credit. Less abundant and more expensive credit is not good for the economy and for the companies most heavily dependent on bank financing.

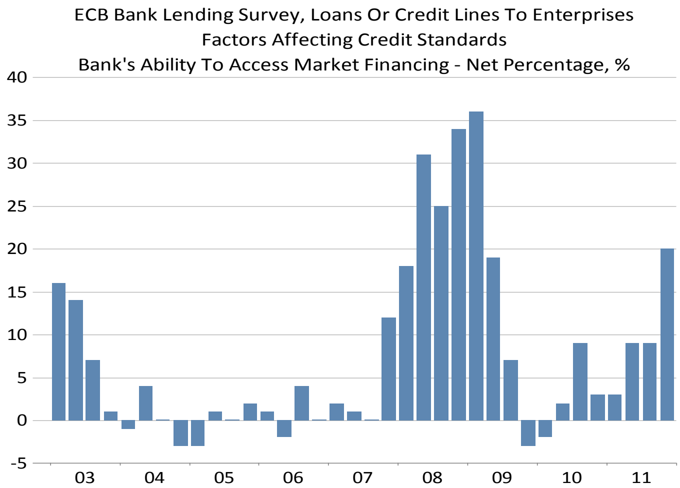
Overall, we have a generally negative tactical bias on credit, with a relative view that is more constructive for the United States than for Europe.

**Tightening of credit conditions by the banks…**




*Source: Bloomberg, BNPPAM*

**…due to more difficult market access**




*Source: Factset, BNPPAM*

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## EMERGING DEBT

### The European debt crisis remains the focus of attention

***Procrastination regarding resolution of the European debt crisis continues to fuel risk aversion***

Due to the fall in risk aversion, the emerging asset class has posted fine performances since the start of October, with external sovereign debt advancing 4.8% thanks to the narrowing of spreads, and with local debt gaining 4.2% (JPM EMBIGD and JPM GBI-EMGD indices respectively, expressed in USD). However, uncertainties regarding the outcome of the public debt crisis in Europe will probably continue to fuel risk aversion, which encourages us to maintain **a cautious position on the emerging debt asset class despite good fundamentals, especially for local-currency debt.**

***Risks of contagion***

**The risks overhanging the outlook for emerging countries remain high**. Apart from the economic impact of the slowdown in global trade, the emerging countries could be impacted by capital outflows to foreign investors (foreign exchange and external debt, but also local sovereign debt, the proportion of which held by foreign investors has increased significantly in recent years) and by a possible pull out by eurozone banks from their exposure to the banking sector of emerging countries (need for recapitalisation). Given the important role played by credit in the economic recovery since 2009, a tightening of credit conditions at present would weigh significantly on emerging countries' domestic demand.

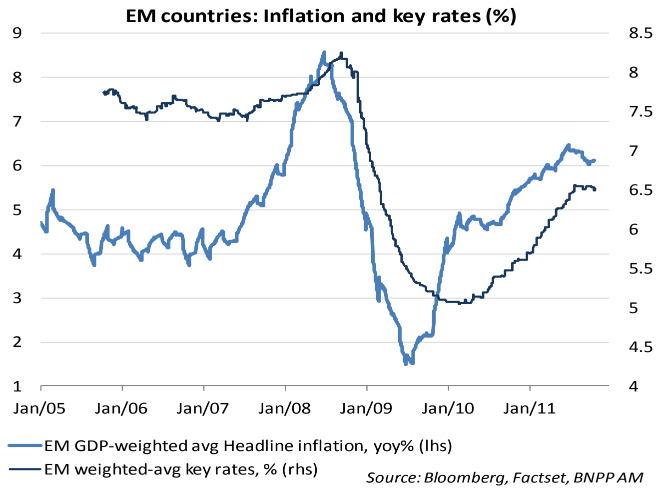
***The inflation peak is behind us***

Against this backdrop, the confirmation of a **slowdown of inflation** in September, although no surprise, was welcome, since the central banks of emerging countries are accordingly in a more comfortable position to ease their monetary policy. However, the magnitude of the policy rate cuts will probably be different from one country to another. In Asia, except for Indonesia and Thailand (impacted by severe flooding), negative real short-term interest rates will probably limit the rate cuts, and fiscal stimulus should be assigned priority to revive the economy and cope with the global slowdown. In Europe, greater exposure to European private banks and recent substantial currency depreciation makes the task more complicated. Moreover, hikes in key policy rates are now expected by the markets, instead of the rate cuts expected only three months ago. On 8 November, the National Bank of Poland maintained the status quo and stated that the depreciation of the zloty adversely affected the inflation outlook. In Latin America, Brazil is likely to continue its easing cycle over the coming months.

**The global economic slowdown and monetary easing** by most central banks are positive factors for local debt, but its performance will probably be offset by currency depreciation. This depreciation should be limited by large foreign exchange reserves allowing the authorities to intervene if necessary, current-account surpluses (in Asia in particular) and a short-term interest-rate differential that is still very attractive, although carry trades are not appealing in a period of high risk aversion.

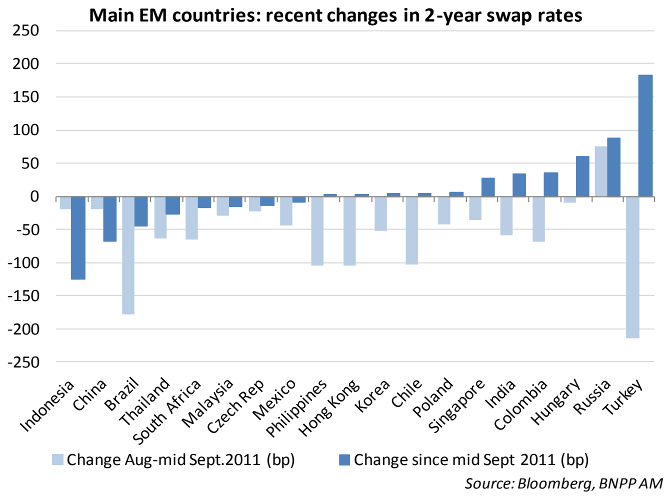
We maintain a neutral position on **emerging external debt:** sovereign spreads are likely to widen in coming months due to the economic slowdown and underlying US rates are already extremely low.

**Monetary easing cycle**




*Source: Bloomberg, Factset, BNPP AM*

**Diverging expectations**




*Source: Bloomberg, BNPP AM*

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# CURRENCY MARKET

## The euro is struggling to find a direction

***The European currency is resilient to developments in the sovereign crisis***

Volatility in foreign exchange markets has remained high in the past two months: it returned above 15% (1-month implied volatility of the EUR/USD) at mid-November, while the EUR/USD exchange rate has moved within a very broad range (1.32–1.42) since the end of September. For example, the euro rose above 1.42 dollars following the European summit of 26 October (its highest level since early September), while it fell below 1.3150 in early October due to expectations of cuts in the ECB's key rates. The violence of this move probably reflects the unwinding of certain speculative positions rather than a real revival of interest in the euro. However, although the ECB indeed lowered its key interest rates on 3 November and hinted that other cuts could be made, the euro has weathered the various events that have shaken the eurozone recently. When the political crisis in Greece and Italy was reaching its paroxysm before the appointment of a new head of the executive in each country to ensure the application of fiscal austerity measures, the euro momentarily fell below 1.36 dollars on 9 November, which represents a limited decline in view of the political uncertainties. Following the appointments of Lucas Papademos in Athens and Mario Monti in Rome, the euro's rise remained equally subdued (1.38 in the morning of 14 November). Market participants are apparently prepared to assign some credit to the latest decisions taken (summit of 26 October, formation of governments of "technocrats" in the countries most keenly watched by investors), but must also take into account the rapid deterioration of the economic situation in the eurozone. The prospect of a relapse into recession will probably weigh on the single currency, which could accordingly stabilise around 1.30 dollars in the medium term (*see table below*).

***The US dollar as a risk barometer***

The analysis of developments in the currency market is made more difficult by the Swiss National Bank's decision in early September to set a lower bound to the EUR/CHF exchange rate (1.20) and by the Bank of Japan's regular threats of intervention to curb the appreciation of the yen. The US dollar is now the key barometer of risk perception, itself fluctuating sharply at present, which results in contradictory moves practically from one week to the next. Against a basket of currencies, the US currency gained 3.7% from 15 September to 4 October, returning close to its annual high of January, it lost 4.7% from 4 to 28 October, and it finally regained 2.2% up to 11 November (calculations based on data published by the Bank of England). Such fluctuations are exceptional in trade-weighted exchange rates, which are traditionally more stable.

***Further intervention by the Bank of Japan***

The Bank of Japan has not merely made threats: on 31 October it intervened directly in the foreign exchange market, managing to push the USD/JPY exchange rate back up from below 76 (a new record for the yen) to above 79.50, a threshold that had been reached at the time of its previous intervention in early August. The exchange rate returned fairly quickly toward 77, which shows that the BoJ intervenes to curb the appreciation of the yen rather than to reverse the trend, an objective that is generally hard to achieve through isolated operations in the currency market. Given that the major international gatherings have been "confiscated" by the European sovereign crisis, concerted intervention does not seem to be on the agenda.

### FX Rate Forecast Summary (Major Currencies)

| End of Period | | 2010 | 09-Nov-11 | 4Q 2011 | | 1Q 2012 | | 2Q 2012 | | 3Q 2012 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Min | Max | Min | Max | Min | Max | Min | Max |
| USD Block | EUR / USD | 1.34 | 1.3708 | 1.25 | 1.35 | 1.20 | 1.30 | 1.20 | 1.30 | 1.20 | 1.30 |
| | USD / JPY | 81 | 78.07 | 75 | 85 | 77 | 87 | 80 | 90 | 80 | 90 |
| | USD / CAD | 0.99 | 1.0192 | 0.97 | 1.07 | 0.97 | 1.07 | 0.95 | 1.05 | 0.95 | 1.05 |
| | AUD / USD | 1.03 | 1.0287 | 0.90 | 1.00 | 0.95 | 1.05 | 0.95 | 1.05 | 0.95 | 1.05 |
| | GBP / USD | 1.57 | 1.6002 | 1.44 | 1.63 | 1.39 | 1.56 | 1.39 | 1.56 | 1.39 | 1.56 |
| | USD / CHF | 0.93 | 0.9019 | 0.92 | 1.00 | 0.96 | 1.04 | 0.96 | 1.04 | 1.00 | 1.08 |
| EUR Block | EUR / JPY | 109 | 107.02 | 98 | 111 | 96 | 109 | 100 | 113 | 100 | 113 |
| | EUR / GBP | 0.86 | 0.8566 | 0.80 | 0.90 | 0.80 | 0.90 | 0.80 | 0.90 | 0.80 | 0.90 |
| | EUR / CHF | 1.25 | 1.2363 | 1.20 | 1.30 | 1.20 | 1.30 | 1.20 | 1.30 | 1.25 | 1.35 |

*Source: BNPP AM as of 07/11/2011*

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# EQUITY MARKETS

## DEVELOPED MARKETS

### Great instability and major risks still justify a cautious approach

***Stabilisation of the economic indicators…except in Europe***

So far, economic reports from outside the eurozone have been fairly reassuring. They continue to point to growth that, although weak, is stable at the global level. This, moreover, has enabled equity markets to show remarkable resilience since September even when public debt and credit markets clearly reflect high tension and rising risks. Now, the situation in Europe is still worrying. The current financial crisis threatens (and the process is even already underway) to spread to the real economy, via financing conditions that continue to deteriorate, but also because of the accelerated adoption of fiscal austerity programmes when there are increasing signs of a marked slowdown in the eurozone.

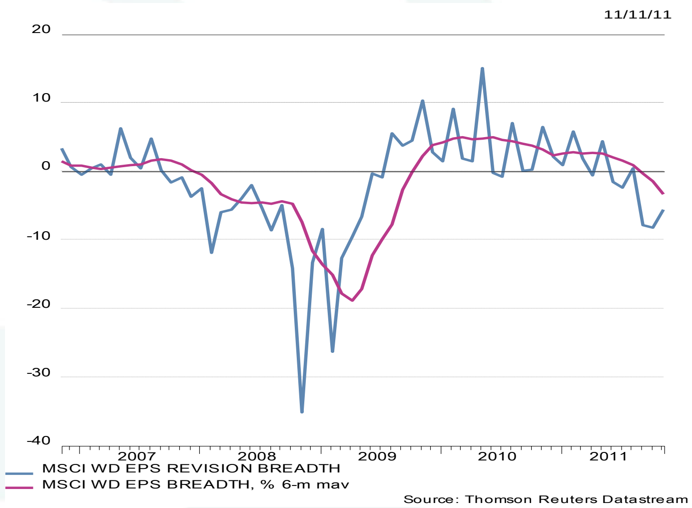
***The European financial crisis must be contained quickly, or else it could spread to other continents***

In this situation, central banks will continue to apply very expansionary monetary policies, which they could, moreover, step up even further. Even the most orthodox central bank, the ECB, has begun to show a certain pragmatism by lowering its rates slightly, despite inflation that is still far above its target. However, given the scale of the crisis in Europe, a major response is required to put an end to a dangerous financial spiral which threatens to spread to other economies. It seems at present that very significant ECB involvement is a prerequisite for a credible solution. However, this possibility has so far been impeded by the ECB's refusal or the impossibility for it of going beyond the scope of its mandate, and by the reluctance of certain eurozone countries to see more significant central bank involvement. For the time being, these political uncertainties and the risk of contagion of the crisis still plead in favour of a cautious approach.

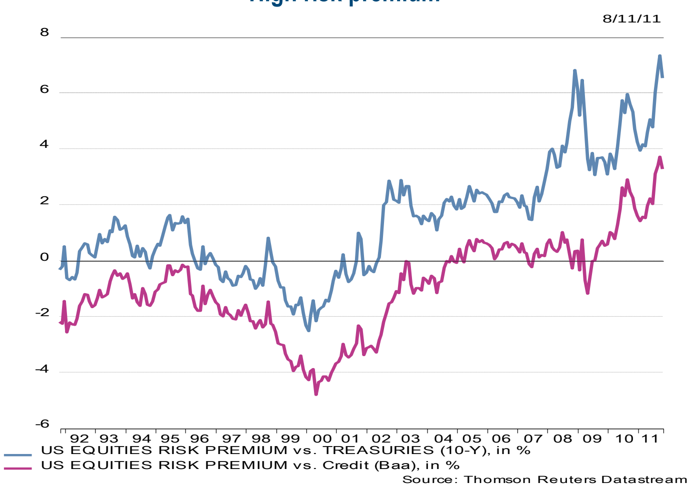
***Downward adjustment of earnings projections not yet ended***

Despite this unstable environment, the third-quarter earnings season now ending seems to send a contradictory message: earnings growth rates that are still robust and high rates of positive surprises, especially in the United States. However, closer analysis shows that the quality of these earnings is declining; the "good" results of the US banks are due more to "creative accounting" than to operating performance, and margins in the other sectors have reached levels that will be hard to maintain in the future in an environment of slowing sales growth. Accordingly, we believe the consensus earnings growth expectations of analysts, who are still looking for further margin growth, are still too optimistic and hence still subject to downward revisions. Moreover, asset writedowns, especially in the financial sector, are likely to gather pace in the wake of the financial crisis. It is therefore still too soon to foresee an end to the trend to a downward adjustment of earnings growth expectations that is currently in progress. As a consequence, market valuations that seem favourable should be viewed in the perspective of this outlook.

**Revision breadth: no inflection in the downward trend**




**High risk premium**



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## DEVELOPED MARKETS

***Apparently favourable valuation levels must be viewed in perspective***

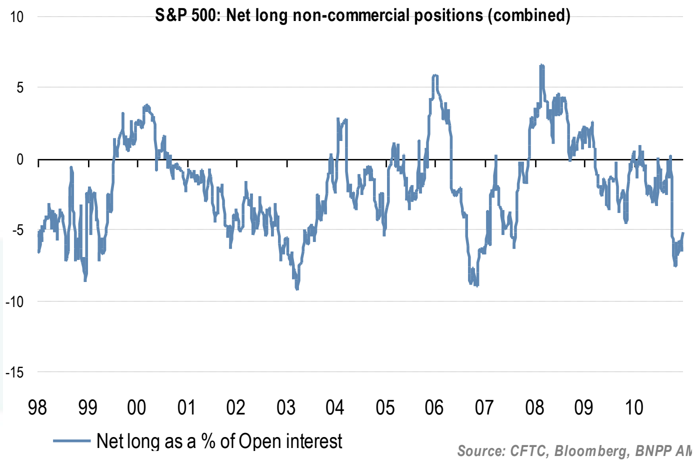
The PERs based on analysts' forward earnings expectations for the next 12 months, which may seem at attractive levels, should therefore be treated with caution due to this continuing downward revision of profit expectations. Moreover, when valuation indicators are analysed over very long periods, e.g. by applying the cyclically adjusted P/E ratio, it can be seen that markets are far from being so attractive as that. The only valuation indicator still clearly positive for equities is the comparison with fixed-income products, corporate bonds and government bonds.

Lastly, the sentiment indicators still show the very cautious attitude of investors — which provides support for the market from a contrarian viewpoint — but caution that is not as extreme as the financial crisis might suggest. Nevertheless, the extremely high level of speculative short positions still represents a very powerful support for the market in the short term, while longer-term the trend indicators are still not sending a Buy message.

***Give priority to the UK and Japanese markets***

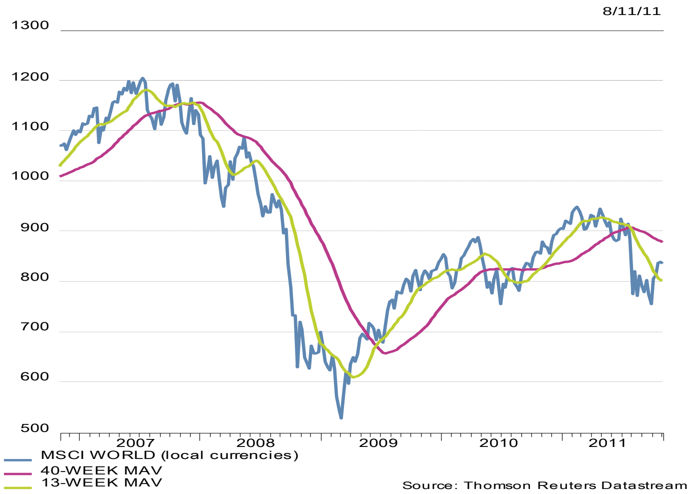
In relative terms, we still prefer the **UK market**. With a low valuation, it should continue to benefit from the Bank of England's extremely accommodative monetary policy and weak sterling. We also continue to prefer the **Japanese market**. This market offers valuations that are extremely attractive in both relative and absolute terms, and we still expect a gradual depreciation of the yen. We adopt a slightly positive exposure to the **Swiss market,** which benefits from a relative weakening of the franc and higher visibility regarding the market trend, but also defensive qualities which offset its exposure to the eurozone and a valuation that is still high. We reduce our exposure to **US equities** to neutral. Their defensive nature in an environment of high risk aversion is still an advantage, but relative earnings revisions are less favourable than in recent months and valuation levels are stretched. We remain cautious on the **Australian market**. The start of a cycle of interest rate cuts is a very positive factor, but this is likely to remain limited, whereas the fall in commodity prices will probably remain a negative. We remain cautious on **eurozone markets**. Although they are still extremely attractive on a relative valuation basis, and recent euro weakening could favourably impact very negative earnings revisions, the risks related to the sovereign crisis and the likelihood of a recession still prevent us from adopting a more positive bias. Lastly, there is no change in our position on the **Canadian market**, which, despite a recent improvement in its earnings revision momentum, is still very expensive.

**Extremely short speculative positions provide short-term support…**




*Source: CFTC, Bloomberg, BNPP AM*

**…but the trend is still bearish**




Source: Thomson Reuters Datastream

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## EMERGING MARKETS

### Cuts in key rates, rise in stock market indices

***Catch-up by emerging indices relative to developed indices, due to renewed risk appetite***

Risk aversion declined sharply in October, allowing emerging equities to rebound by more than 14% and 19%, in local currency and in USD respectively. But most investments are made via ETFs, reflecting still relatively weak conviction. At the same time, CDS contracts for the main emerging countries have returned to more rational levels. In terms of valuation, emerging indices trade at a discount of more than 15% relative to developed stock markets, while posting higher earnings growth and lower volatility. Markets are trading at 9.4 times earnings, the most attractive level since 2008.

We maintain a preference for emerging markets, even though their historically higher "beta" and their high sensitivity to international fund flows make them more exposed to the volatility of developed markets. Risk appetite is back and will probably stay thanks to good fundamentals and expectations of monetary easing. Some large countries such as Brazil and Indonesia have lowered their key interest rates, while India and China are in pause mode.

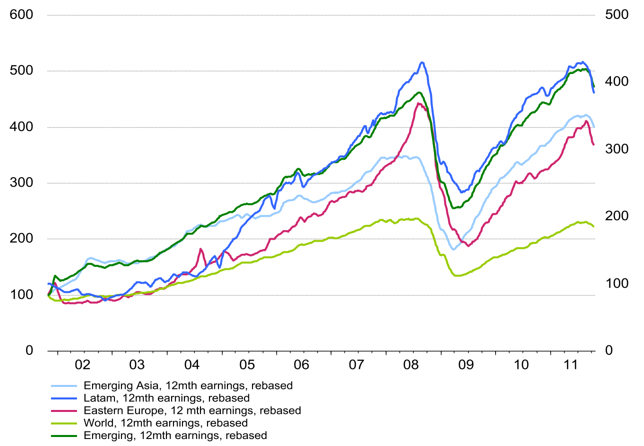
The Chinese economy is starting a soft landing, which is positive for emerging economies because China has become a very important economic partner. Chinese monetary policy is in a transition phase, and easing measures are likely to be adopted at the start of next year. The confirmation of a fall in the reserve ratio, or of growth in the monetary aggregates, will be very positive for emerging stock markets in general, and for the Chinese market in particular.

***Inflection in Chinese monetary policy***

We maintain a positive bias on **China**. The economy is slowing down gently. Inflation peaked in July and the trend is clearly downward, as shown by the latest figure of 5.5%. Real estate prices are at last falling, and it is very much in the interest of the authorities that the magnitude of this fall be well controlled, given the importance of real estate for the economy and for consumer confidence. Monetary policy is in a transition phase, in which the authorities will first start targeted easing to stimulate small and medium-sized businesses, public housing and certain infrastructure projects. The trend in the monetary aggregates is crucial for stock market performance over the coming months. Lastly, valuations and investor sentiment are still at depressed levels.

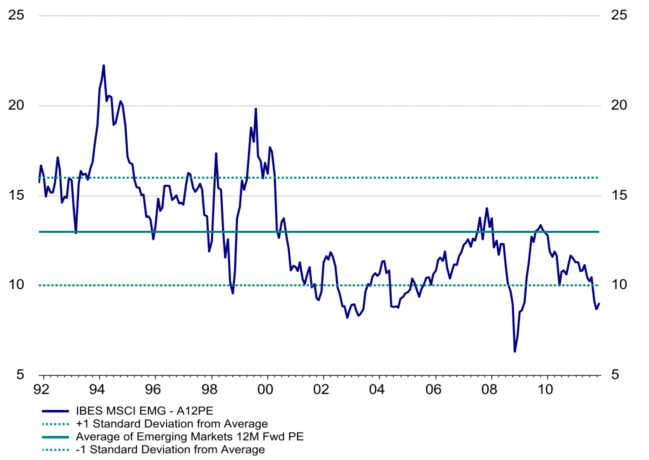
We reduce the overweighting of **Russia** following its sharp rebound. Moreover, Russia's "beta" relative to the eurozone is one of the highest among emerging countries. Being a major commodity and energy exporter, its economic and financial prospects are very dependent on the global economic environment, and in particular on oil prices. Russian equities are among the least expensive in the world and have sharply underperformed the price of Brent.

**Downward earnings revisions: just starting**




Source: Thomson Reuters Datastream

**Very attractive valuation**




Source: Thomson Reuters Datastream

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## EMERGING MARKETS

### Increase in the positive bias for domestic economies

***Neutral on India, South Africa and South Korea***

We retain our slight positive bias for **India**. The Indian PMI Index improved in October, which shows that economic activity is suffering only slightly from the monetary tightening. However, inflation, and not the slowdown in the global economy, is the greatest risk faced by the central bank. We believe that inflation will remain high, especially since the recent rise in core inflation, and that it is therefore necessary for interest rates to stay at the current levels for an extended period. Moreover, earnings revisions are still to the downside.

We remain neutral on **South Africa**, which is likely to see its growth revised downward due to lower trade with its main trade partners. However, the PMI indicator is once again above 50 and business sentiment has stabilised.

Following a very strong outperformance, we reduce **South Korea** to neutral to limit the risks due to the cyclical nature of its economy and the uncertainties currently prevailing in developed markets. The latest South Korean PMI figure of 47.5 is a sign that growth is slowing, but there is no sign of a collapse in activity. Inflation is still a worry, but the central bank has decided to pause in its monetary tightening given global economic weakness. Lastly, valuations are attractive but earnings prospects are poor.

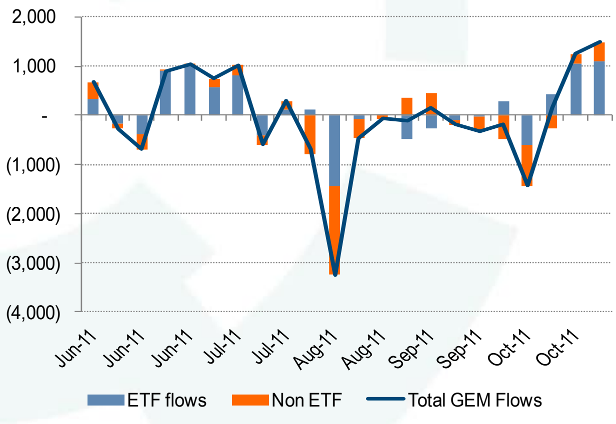
***Caution regarding Taiwan and Turkey***

We maintain our negative stance on **Taiwan** because the economy is highly cyclical and exposed to the United States and Europe. Significant earnings downgrades reflect weaker demand in both domestic and foreign markets. Moreover, the presidential and parliamentary elections in January add further sources of volatility to the theme of cross-strait relations between Taiwan and China. Earnings prospects are limited. The impact of weak foreign demand is becoming obvious and is reflected by a sharp deterioration in industrial output. Equities are fairly priced by comparison with other emerging markets.

We maintain a slight underweighting on **Brazil**. The central bank has lowered the key interest rate by 50 bp for the second time since August, convinced that the global slowdown would help inflation subside in 2012. Inflation did indeed slow down for the first time in the past 14 months, to 7.1%. A negative global environment could have an impact on Brazil's growth in the coming quarters. The numerous government measures to prevent appreciation of the Brazilian real have been effective until now.

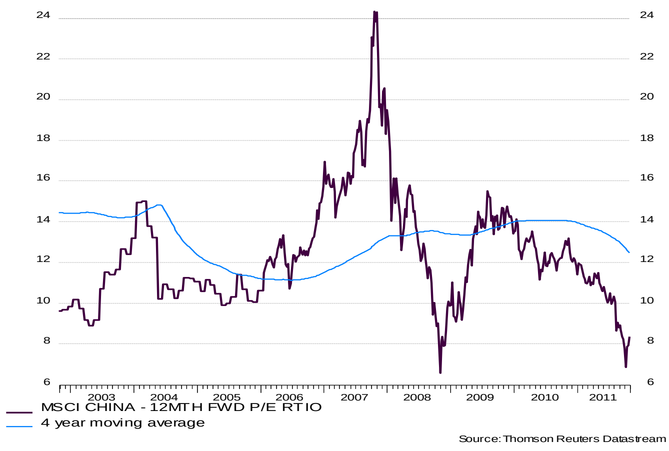
The bias on **Turkey** is still broadly negative. The central bank decided to raise all interest rates except the key policy rate, which remains unchanged, so as to have room for manoeuvre if economic uncertainties were to increase considerably, especially in the eurozone. The Turkish stock market was the only one in the emerging universe to post a negative performance in October. Earnings revisions are to the downside.

**Resurgence of funds flows to emerging countries (in USD million)**




Source: Samsung Securities, EPFR.

**Chinese equity valuations are at a low**




Source: Thomson Reuters Datastream

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# ALTERNATIVE STRATEGIES

## COMMODITIES

### Preference for gold. Neutral on other commodities

***Growing pressure in oil markets remains likely in the medium term if recession is avoided***

**Crude** prices stabilized in recent weeks, with Brent remaining around the USD 110-115 level. While worries regarding the slowdown in global growth persist, the fundamentals for oil have remained sound. For example, petroleum product stocks continue to decline - in both the United States and Europe – despite mixed domestic demand and the gradual resumption of Libyan oil production, which suggests that global demand remains firm. In this context, tensions in the Middle East around the situation in Syria and the Iranian nuclear programme should keep the "geopolitical premium" for oil supported (even though we believe that the risk of an event significantly impacting oil production is very low). In the short term, however, we believe that the macroeconomic figures will remain the main factor determining oil prices. **We remain neutral on oil**.

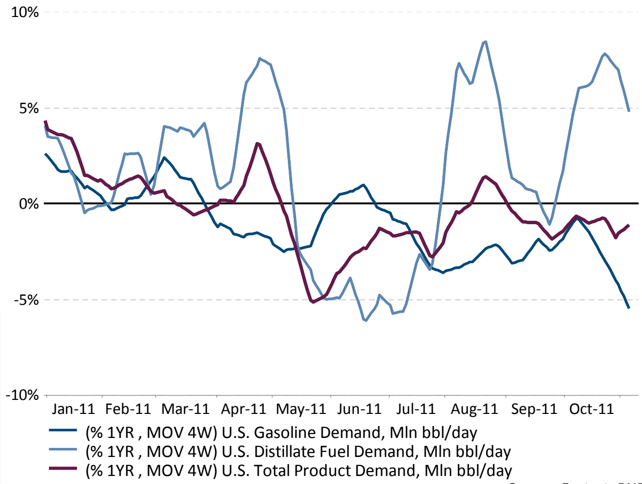
Following the sharp correction in September, **base metals** had a mixed performance in October, copper being the only metal to stage a rebound. The slowdown in global growth is likely to result in lower demand for industrial metals. However, copper demand has shown signs of good health, with a confirmation of the increase in China's imports to rebuild its stocks. While this decision is probably partly opportunistic, since prices have fallen 20% since July, it also underlines the fact that the downside risks are limited so long as the major emerging economies remain in good health. However, a lasting rebound in prices is unlikely in our view. **We remain neutral on base metals**.

***Investor appetite for gold should remain firm, supporting prices***

Following the drastic correction in September, **gold** prices resumed their upward trend, going so far as to test USD 1,800. Meanwhile, speculative positions stabilized at moderate levels, which suggests a limited risk of a further round of risk reduction. Moreover, the extension of the QE programme in the UK and the ECB's interest rate cut confirm our view that monetary policies should remain very favourable to investment demand for the metal. **We remain positive on gold**.

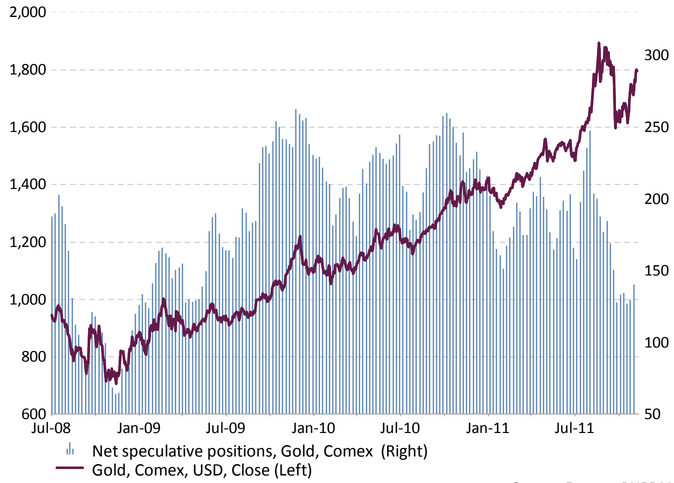
**Grain** prices struggled to rebound in October despite renewed risk appetite. Only corn really advanced, mainly due to demand linked to ethanol production in the United States. Soybeans and wheat, on the other hand, have been increasingly suffering from global competition, which led the US Department of Agriculture to revise downward its estimates of export demand for these cereals. **We are neutral on cereals**.

**Oil demand remains mixed in the United States**




*Source: Factset, BNPPAM*

**Speculative positions on gold are at moderate levels**




*Source: Factset, BNPPAM*

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# CONTACTS & DISCLAIMER

The charts in this document were updated in November 2011, unless otherwise specified. BNPP IP is the source as of 14 November 2011 for all data commented in this document unless otherwise specified.

## Strategy Team:

Vincent Treulet

Nathalie Benatia
Antonio Bertone
Charles Cresteil
Jenna Dessart
Sophie Fournier
Guillaume Hollier-Larousse
Dong-Sinh Ngo
Dominique Schulthess

## Investment Specialist:

Joost van Leenders

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